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IN THE

Supreme Court of the United States

October Term, 1962

No. 670

IN THE MATTER

OF

NOVO-PLAS MFG. CO., INC.,

Bankrupt.

—o—

NATHAN HAUPTMAN, Trustee,

Petitioner-Appellant.

DIRECTOR OF INTERNAL REVENUE, RAYMOND ZURAWIN, and ROSE ZURAWIN,

Respondents-Appellees.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. .....

In the Matter

of

NOVO-PLAS MFG. CO., INC.,

Bankrupt.

NATHAN HAUPTMAN, *Trustee,*

Petitioner-Appellant,

DIRECTOR OF INTERNAL REVENUE, RAYMOND ZURAWIN, and ROSE ZURAWIN,

Respondents-Appellees.

PETITION FOR WRIT OF CERTIORARI

To the Honorable, the Chief Justice and the Associate Judges of the Supreme Court of the United States:

Nathan Hauptman, the Trustee in Bankruptcy of Novo-Plas Mfg. Co., Inc., petitions for a writ of certiorari to review a judgment and order (24, Appendix II hereof) of the United States Court of Appeals for the Second Circuit, entered September 18th, 1962, which affirmed a judgment and order of the United States District Court for the Eastern District of New York, which in turn affirmed the order of the Referee in Bankruptcy holding that

the net operating loss of a "small business corporation" which had elected to have a tax status pursuant to Subchapter S of Internal Revenue Code of 1954 was not available, under the facts of this case, for use by the Trustee.

Summary Statement of the Matter Involved

The Pleading

This proceeding was instituted by the Trustee before the Referee in Bankruptcy for an order recognizing only the Trustee as the one entitled to utilize the bankrupt corporation's operating loss for the calendar years 1957 and 1958 as the basis for a tax refund of income taxes paid for the years 1955 and 1956.

It appeared from the pleadings, without dispute, that Novo-Plas Mfg. Co., Inc., a New York corporation, filed its corporate income tax returns from 1946 through 1957 on a calendar year basis. In 1955 and 1956, its return disclosed taxable income upon which it duly remitted taxes to the District Director of Internal Revenue. In 1957, the corporation suffered a net operating loss of $10,424.93. On May 6, 1958 one, Raymond Zurawin became the sole stockholder of the bankrupt. During 1958, the corporation incurred a net operating loss of $184,535.70; it did not pay all of its employment, social security and withholding taxes (4a, par. 7).

On September 2, 1958, the Internal Revenue Code was amended to create Subchapter S, Sections 1371-77; any corporation that could qualify as a small business corporation under that Subchapter was granted 90 days within which to elect to receive the tax treatment permissible under these amendments. The bankrupt, having but one

stockholder, was eligible, and on November 29, 1958 elected to receive small business tax treatment under Subchapter S. (7a, par. 13).

On January 23, 1959, Novo-Plas assigned its assets for the benefit of creditors under an assignment duly filed under New York State Law. On February 16, 1959, an involuntary petition in bankruptcy was filed against Novo-Plas and on March 23, 1959, it was adjudged a bankrupt (4a, par. 5).

The District Director of Internal Revenue has filed a claim in the bankruptcy proceeding for $7,155.61 alleged to be employment, social security and withholding taxes unpaid and due for the years 1958 and 1959 (5a, par. 9).

On September 2, 1959, the Trustee, by two separate refund claims, filed with the Director, made claim for a tax loss carry-back refund, based on the bankrupt's above-mentioned operating losses for 1957 and 1958 (5a, par. 8). If this refund application had been granted, this sum would offset the amount claimed by the Director against the corporation.

In the same year, Raymond Zurawin, the bankrupt's sole stockholder and his wife, filed a claim for a refund of income taxes which they had paid and asserted that the net operating loss of the corporation for 1958 was allowable to them personally rather than to the corporation because of the election the corporation had made on November 29, 1958, under Section 1372(a) of the Internal Revenue Code (8a, par. 14).

The Trustee then moved the Referee in Bankruptcy for an order recognizing only the Trustee, to the exclusion of the Zurawins, as the one entitled to utilize the bankrupt corporation's operating loss for 1957 and 1958 as a basis

for a tax refund of income taxes paid by the corporation for 1955 and 1956, and to restrain the Zurawins from utilizing said operating losses as a basis for personal tax loss carry-back.

At the Referee's hearing, the Director of the Internal Revenue and the Zurawins both conceded that with respect to the net operating loss incurred by the bankrupt corporation in 1957, only the Trustee could utilize the operating loss as the basis for a tax credit and carry-back as against income taxes paid by the bankrupt for the calendar taxable years 1955 and 1956; but the Referee found (12a), that inasmuch as the corporation had timely elected to be treated, taxwise, as a small business corporation for the year 1958, the 1958 operating loss of the bankrupt corporation could be utilized only by the shareholder Zurawin.

The Trustee thereupon petitioned the United States District Court for the Eastern District of New York to review the Referee's order.

The District Court's Decision

The District Court affirmed the Referee in a memorandum opinion (Appendix I). The Trustee thereupon appealed to the United States Court of Appeals for the Second Circuit.

The Court of Appeals' Decision

The Court of Appeals' opinion (18, Appendix II hereof), reported in .. F. (2d) .., affirmed the District Court in an opinion which held that the language of the Code does not limit the right of the shareholder to avail himself, for his personal use, of the net operating loss in-

curred by the bankrupt corporation in a situation in which the election to qualify as a small business corporation was made at a time when the corporation was hopelessly insolvent and when such insolvency was followed shortly after such election by the bankrupt's assigning its assets for the benefit of creditors and ultimately being adjudged a bankrupt.

The Pertinent Statute

Section 1374 of the Internal Revenue Code, a part of Subchapter S, provides in pertinent part:

> "(a) General Rule.—A net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross income of the shareholders of such corporation in the manner and to the extent set forth in this section."

Jurisdiction

The judgment and order of the Court of Appeals was entered on September 18, 1962. The jurisdiction of this Court to review by writ of certiorari the judgment and order complained of is conferred by Title 28 U. S. C. 1254 (Appendix III hereof).

Questions Presented

1. Under Subchapter S of the Internal Revenue Code of 1954 (Sections 1371-77), enacted on September 2, 1958, is the Trustee of the bankrupt corporation, or is its individual shareholder, entitled—the one to the exclusion of the other—to the right to utilize the bankrupt corpora-

tion's 1958 operating loss as a basis for tax deductions by carrying back the net operating loss for that year and applying it against taxes paid for the years 1955 and 1956?

2. Should an election made by a sole shareholder under Subchapter S, to qualify as a small business corporation, made at a time when the corporation was hopelessly insolvent, which insolvency was followed shortly thereafter by the bankrupt's assigning its assets for the benefit of creditors and subsequently being adjudicated a bankrupt, be disregarded as an inequitable expropriation by said shareholder of tax loss credits, which, prior to the 1958 amendment to the Code were recognized as being the exclusive property and right of the Trustee in Bankruptcy.

Reasons for Granting the Writ

The Court below decided substantial questions of Bankruptcy Law contrary to statute and not in accordance with applicable decisions of this Court and the United States Constitution.

We urge:

1. That the questions involved herein were decided erroneously by the Court below, are substantial, are likely to recur, are of national importance, and petitioner has been deprived of his property and rights in violation of law.

2. Questions 1 and 2, which involve the resolution of the dispute between the Trustee in Bankruptcy, on the one hand, and the sole shareholder, on the other, as to which of these two has the right to utilize the tax loss

credits of a small business corporation in circumstances, under which the election to qualify as a small business corporation under Subchapter S of the Code was made by the shareholder at a time when the corporation was hopelessly insolvent (and the insolvency of which was followed by an assignment for the benefit of creditors and subsequently by an adjudication of bankruptcy), has never otherwise been passed upon by this or any Federal Appellate Court.

The amendment to the Code which, for the first time established the concept of the "small business corporation", was first enacted on September 2, 1958, and has not yet been passed upon or interpreted by any Appellate Court other than in the course of this appeal. The issue implicit in this appeal—namely the contest between the Trustee of a bankrupt "small business corporation" and the shareholder of such a bankrupt corporation to the exclusive use of tax credits—will arise with increasing frequency in our Courts.

We therefore urge that the far-reaching effect of the decision below and its removing from the reach of creditors of a substantial property right under circumstances which render such removal inequitable, impels that in the public good the propriety of the order of the Court below be passed upon by this Court.

Argument

We shall show in the argument which follows that the tax credits of a bankrupt "small business corporation" flowing from its operations prior to its insolvency may be utilized only by the Trustee for the benefit of the bankrupt's creditors, to the exclusion of its shareholder, who claims such right pursuant to an alleged election to

qualify as a "small business corporation" made at a time when the bankrupt was hopelessly insolvent.

It has been the established and uninterrupted practice in our Courts to allow only the trustee in bankruptcy to utilize, as the basis for a tax loss carry-back, all the bankrupt's tax credits inherent in and flowing from the bankrupt's operations prior to its insolvency.

Were it not for the enactment of Subchapter S in 1958, there would be no problem in disposing of the trustee's application to be declared the only one who may utilize the bankrupt's tax loss credits.

This established practice of recognizing the right of the creditors to the bankrupt's tax credits enables the trustee to marshal all the bankrupt's assets, including its tax credits, into a common fund out of which creditors may realize a dividend on their claims. In fact, the respondents conceded, at the hearing before the Referee, that the bankrupt's tax credits, based upon its operating loss in 1957—prior to the 1958 enactment of Subchapter S—may be utilized only by the Trustee, to the exclusion of the shareholder.

Subchapter S was enacted to relieve small business corporations from the burden of double taxation which resulted from the conducting of business enterprise by means of a corporate structure rather than by partnership or individual proprietorship. In order to grant small business corporation relief from this form of double tax, Congress, in 1958, enacted Subchapter S, as an amendment to the Internal Revenue Code. It is submitted, however, that Congress, by this enactment, did not intend to alter the previous recognition by the bankruptcy Courts of the rights of the creditors, to the exclusion of the shareholders, to recoup the bankrupt's tax

credits based upon the bankrupt's business operations prior to its insolvency.

Congress, by this 1958 enactment, intended that Subchapter S was to give relief to "small business corporations", as there defined, subject, however, to continuing the established policy of recognizing the paramount right of creditors to all assets emanating from or recoverable as a result of the previous operations of the bankrupt.

While the statute itself is silent as to the intent of Congress on this score, namely the impact of Subchapter S on the established and recognized exclusive right of a trustee in bankruptcy to the use of a corporate bankrupt's tax credits, it cannot fairly be urged that Congress intended to give relief from double taxation to a bankrupt "small business corporation", or to its shareholders, to the substantial detriment and at the expense of creditors of the bankrupt corporation.

It is respectfully urged that Congress would not, without specific declaration in the statute, deprive corporate creditors of this valuable tax credit which was built upon income tax payments made during the bankrupt's lush years, and hand them over to the shareholder of a bankrupt small business corporation, thereby placing such assets beyond the reach of the bankrupt's creditors and giving an unintended gift to the shareholder.

The inequity of the interpretation by the Court below of Subchapter S is evident from the fact that the bankrupt in this proceeding filed its election to qualify as a small business corporation on November 29, 1958, less than two months before it filed its assignment for the benefit of creditors, and that such election was filed at a time when, as shown clearly and irresistibly by the testimony before

the Referee in Bankruptcy, the corporation was hopelessly insolvent.

Subchapter S should not so be interpreted as to vest in a small business corporation the absolute power, in its unchallengable discretion, to file or not to file its election to qualify as a small business corporation at a time when it is hopelessly insolvent, and thereby empower the bankrupt corporation, acting by its shareholder, to permit or not to permit the unpaid creditors of the bankrupt corporation to utilize the substantial tax credits of the bankrupt corporation.

What Congress did intend to accomplish by enacting Subchapter S was to say to small business corporations that insofar as the law of the State in which the bankrupt was incorporated was concerned, the bankrupt continued in all respects to be a corporation; that such small business corporation continue to enjoy all the customary attributes and immunities of a corporation, such as limited liability, continuity of existence, etc., but that insofar as the imposition of Federal income taxes was concerned, this small business corporation was to be treated as if it were an individual—not a corporation—and thereby avoid the burden of double taxation on corporate earnings.

However, this privilege of avoiding double taxation is subject and subordinate to the overriding liability of the bankrupt corporation to make available to its unpaid creditors all its assets, including all its tax credits. It is only when there is no problem of unpaid creditors of a bankrupt corporation that the individual shareholder of such a bankrupt corporation should be in a position to make claim for his personal use of these corporate tax credits.

It is relevant here to note that if this bankrupt had been an individual—not a corporation—the tax credits accumulated by such individual bankrupt would become available to his trustee in bankruptcy—to the exclusion of the bankrupt. Why, then, should the fact that this bankrupt was a corporation, rather than an individual, deprive the corporate creditors of the tax credits accumulated by the corporation resulting from its business operations, and bestow these tax credits as a gift to the shareholder, free from creditors' claims?

If respondent's position be sustained, then the mere adventitious factor that the bankrupt was a corporation, rather than an individual, would result in removing from the reach of corporate creditors all the tax credits earned by the corporate bankrupt, in the face of the fact that if the bankrupt had been doing business as an individual, such tax credits would unchallengably be available exclusively to the creditors.

The trustee submits that it is unfair and inequitable, and contrary to the intent of Congress, to permit the sole shareholder (himself insolvent as appears from the record), to siphon off for his own use the tax credits accumulated by an insolvent and ultimately bankrupt "small business corporation"—tax credits which were built up by the corporate bankrupt's assets—and thereby deprive the unpaid creditors of the bankrupt of this valuable property right.

The 1958 amendment to the Code was intended to be a shield—not a sword—for the benefit of small business corporations and their shareholders, provided, however, that all corporate assets—including tax credits based upon the corporation's operations—first be applied to the claims of creditors.

Moreover, it is unjust and inequitable, and contrary to the rationale of both the Bankruptcy Act and Subchapter S, to require the trustee to pay to the Director of Internal Revenue, out of estate funds, the amount due the Director on his priority tax claim of some $7,100.00, and at the same time to permit the Director to recognize the sole shareholder of the bankrupt as the one—to the exclusion of the Trustee—to whom all tax credits emanating from the bankrupt's 1958 operating loss are to be paid or credited.

In effect, the bankrupt's creditors are being required to pay, with estate funds, the personal tax liability of the bankrupt corporation's sole shareholder and sole operating executive, at a time when there is in existence the substantial 1958 tax credit which would completely offset the Director's tax claim against the trustee.

The trustee submits that in light of the ruling of this Court in *Pepper* v. *Litton*, 308 U. S. 295 (1939), it is inequitable to permit the bankrupt's sole shareholder, instead of the bankrupt's creditors, to take advantage of the bankrupt's substantial tax deduction, especially in view of the fact that the election to qualify as a small business corporation was made on the initiative of the bankrupt's sole shareholder at a time when the bankrupt was hopelessly insolvent, thereby effecting preferential treatment of this sole shareholder at the expense of creditors.

As stated in *Pepper* v. *Litton*, *supra*:

> "• • • A director is a fiduciary. So is a dominent or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subject to rigor-

ous scrutiny and where any of the contracts or engagements of the corporation is challenged, the burden is on the director or stockholder not only to prove the good faith of the transaction, but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's-length bargain. If it does not, equity will set it aside. While normally that fiduciary obligation is enforceable directly by the corporation, or through a stockholder's derivative action, it is, in the event of bankruptcy of the corporation, enforceable by the Trustee. For that standard of fiduciary obligation is designed for the protection of the entire community of interests in the corporation—creditors as well as stockholders * * *.

"It is also urged where on the facts the bankrupt has been used merely as a corporate pocket of the dominant stockholder, who, with disregard of the substance or form of corporate management, has treated its affairs as his own. * * *

"At times, equity has ordered disallowance or subordination (of shareholder's claims) by disregarding the corporate entity. That is to say, it has treated the debtor-corporation simply as part of the stockholder's own enterprise, consistently with the course of conduct of the stockholder. But in that situation, as well as in the others to which we have referred, a sufficient consideration may be simply the violation of rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corpo-

ration, its stockholders and creditors. He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot, by the intervention of a corporate entity, violate the ancient precept against serving two masters. He cannot, by the use of the corporate device, avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly, through the corporation, what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is, at all times, subject to the equitable limitation that it may not be exercised for the aggrandisement, preference or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. Where there is a violation of these principles, equity will undo the wrong or intervention to prevent its consummation * * *.

"No matter how technically legal each step in that scheme may have been, once its basic nature was uncovered, it was the duty of the bankruptcy court by its equity jurisdiction to undo it. Otherwise, the fiduciary duties of dominant or management stockholders would go for nought; exploitation would become a substitute for justice; and equity would be perverted as an instrument for approving what it was designed to thwart."

IN CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

HARRY H. SCHUTTE,
Attorney for Petitioner.

LOUIS P. ROSENBERG,
Of Counsel.

S. A. HAUPTMAN,
On the Brief.

Both of Brooklyn, N. Y., for Petitioner-Appellant.

APPENDIX I

Opinion of the United States District Court for the Eastern District of New York

Petition to review order dated May 12, 1961, made by Louis J. Castellano, Referee.

On November 29, 1958, the bankrupt made an election in accordance with 26 U. S. C. 1372, known as subchapter S of the Internal Revenue Code. The effect of the election is described in 26 U. S. C. §1372(b); subsection (1) states that "* * * such corporation shall not be subject to the taxes imposed by this chapter * * *." Subdivision (2) states that "* * * the provisions of Sections 1373, 1374, and 1375 shall apply to such shareholder * * *."

Section 1374 states:

> "A net operating loss of an electing small business corporation for any taxable year shall be allowed as
>
> [103]
>
> a deduction from gross income of the shareholders of such corporation in the manner and to the extent set forth in this Section."

The bankrupt suffered a net operating loss of $184,535.70 in the taxable year 1958.

The Referee in his order subject to review here, held that the loss carry back may be utilized only by the shareholder.

The Trustee argues that the Referee should have found that subchapter S applies only to a going operating corporation and that Congress only intended to give relief to corporations intending to continue in business. There

is nothing in the language of the statute indicating such an intent.

The Referee's opinion (page 5) points out that originally a proposed regulation provided that a "corporation * * * in the process of complete or partial liquidation * * * " was ineligible to make the election under subchapter S. The Bureau became convinced that the statute intended making such election available to corporations that were in

[104]

the process of complete or partial liquidation or intended such liquidation, and the proposed regulation herein referred to, was deleted. See 18 N. Y. U. Institute on Federal Taxation, page 664 (edited by Henry Sellin; 12 U. C. L. A. Tax Institute, page 194).

The Order appealed from is affirmed. Settle order on two days notice.

JACOB MISHLER,
U. S. D. J.

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APPENDIX II

Opinion of United States Court of Appeals for the Second Circuit

WATERMAN, *Circuit Judge*:

Novo-Plas Mfg. Co., a New York corporation from 1946 through 1957, filed its corporate income tax returns on a calendar year basis. In 1955 and 1956 its returns disclosed taxable income in the approximate sum of $29,000, upon which it duly remitted taxes to the District Director of Internal Revenue. In 1957 the corporation suffered a net operating loss of $10,424.93. On May 6, 1958, one Raymond Zurawin became the sole shareholder of Novo-Plas Mfg. Co., Inc. The corporation allegedly incurred a net operating loss of $184,535.70 during 1958, and apparently did not pay all of its employment, social security, and withholding taxes.

On September 2, 1958, the Internal Revenue Code was amended to create Subchapter S, Sections 1371-77; and any corporation that could qualify as a small business corporation under that subchapter was granted 90 days within which to elect to receive the tax treatment permissible under these amendments. Novo-Plas Mfg. Co., Inc., having but one stockholder, was eligible, and on November 29, 1958, elected to receive small business tax treatment under Subchapter S.

On January 23, 1959, Novo-Plas assigned its assets for the benefit of creditors, by an assignment duly filed under the New York State law. On February 16, 1959, an involuntary petition in bankruptcy was filed against the corporation, and on March 23, 1959, it was adjudged a bankrupt.

The petitioner-appellant herein is the trustee in bankruptcy. The District Director of Internal Revenue has

filed a claim in the bankruptcy proceeding for $7,155.61, alleged to be employment, social security, and withholding taxes unpaid and due for the years 1958 and 1959. On September 2, 1959, the trustee, by two separate refund claims filed with the Director, made claim for tax loss carry-back refund based on the bankrupt's above mentioned operating losses for 1957 and 1958. If the refund applications had been granted, this sum would offset the amount claimed by the Director against the corporation.

In the same year Raymond Zurawin and wife filed a claim for a refund of income taxes that they had paid, and asserted that the net operating loss of the corporation for the year 1958 was allowable to them personally rather than to the corporation because of the election the corporation made on November 29, 1958, under Section 1372(a) of the Internal Revenue Code. The trustee then moved the referee in bankruptcy for an order recognizing only the trustee, to the exclusion of the Zurawins, as the one entitled to utilize the bankrupt corporation's operating loss for the calendar years 1957 and 1958 as a basis for a tax refund of income taxes paid for the years 1955 and 1956, and to restrain the Zurawins from utilizing the operating losses as a basis for personal tax loss carry-back.

At the referee's hearing the Director of Internal Revenue and the Zurawins both conceded that with respect to the net operating loss incurred by the bankrupt corporation in the calendar year 1957 only the trustee could utilize that operating loss as the basis for a tax credit and carryback as against income taxes paid by the bankrupt for the calendar, taxable years 1955 and 1956; but the referee found, in accordance with the provisions of Subchapter S of the Internal Revenue Code of 1954, that,

inasmuch as the corporation had timely elected to be treated taxwise as a small business corporation for the year 1958, the 1958 net operating loss of the bankrupt corporation could be utilized only by the shareholder, Zurawin. The trustee petitioned the United States District Court for the Eastern District of New York to review the referee's order. The court affirmed the referee in a memorandum opinion, and from the order of the court the trustee appeals.

The only issue before us is whether the trustee of the bankrupt corporation or the individual shareholder is entitled to the right to utilize the bankrupt corporation's 1958 operating loss as a basis for tax deductions by carrying back the net operating loss for that year and applying it against taxes paid for the year 1955 and 1956.

Section 1374 of the Internal Revenue Code, a part of Subchapter S, allows the shareholders of a corporation qualifying under that subchapter to deduct on personal income tax returns for the net operating loss incurred by the corporation.[1] A related section, Section 172(h) of the

[1] Section 1374 provides in pertinent part:

(a) General Rule.—A net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

* * * * * *

(c) * * *

(2) Limitation.—A shareholder's portion of the net operating loss of an electing small business corporation for any taxable year shall not exceed the sum of—

(A) the adjusted basis * * * of the shareholder's stock in the electing small business corporation * * * and

(B) the adjusted basis * * * of any indebtedness of the corporation to the shareholder * * *

Code, precludes the corporation from taking a net operating loss deduction when such deduction is taken by the shareholders of the corporation and used by them to reduce their respective personal income tax liabilities.

Reminding us that a court sitting in bankruptcy is a court of equity and relying heavily on *Pepper* v. *Litton*, 308 U. S. 295 (1939), the bankruptcy trustee in the present case asserts that it would be inequitable to permit the bankrupt's sole shareholder, instead of the bankrupt's creditors, to take advantage of the large tax deduction which is at issue here. In the *Pepper* case the Supreme Court held that a claim for unpaid salary filed by the sole shareholder of the bankrupt corporation there involved should be disallowed inasmuch as the claim was an unconscionable attempt to swallow up all of the corporate assets and thus avoid liability for a debt the corporation owed to a general creditor.

We are aware of the equitable nature of bankruptcy proceedings. See e.g., *Pepper* v. *Litton*, *supra*, at 304; *Local Loan Co.* v. *Hunt*, 292 U. S. 234, 240 (1934). However, permitting the shareholder to avail himself of the net operating loss incurred by the bankrupt corporation here would not appear to be so unfair that equity requires us to determine this appeal in the trustee's favor. The trustee would have us hold that an otherwise qualifying corporation may not elect Subchapter S tax treatment when the corporation is insolvent or when corporate bankruptcy is imminent. The language of the Code does not refer to such a limitation upon the shareholders' power to elect Subchapter S treatment. The so-called equitable considerations urged upon us by the trustee are substantially weakened by the fact that the present litigation is as much a squabble between two sets of creditors—the

Government, a preferred creditor, on the one hand, and the remaining creditors on the other—as it is a dispute between the sole shareholder of the bankrupt corporation and the bankrupt's creditors.

The trustee contends that it is unjust to allow the shareholder of a one-man corporation to elect under Subchapter S and thereby personally receive the use of the deduction for the corporation's net operating loss at a time when liquidation of the corporation is foreseeable. In Section 1374, however, Congress invited shareholders of small business corporations to avail themselves of the tax advantage derived from using their corporation's net operating losses as deductions on their personal income tax returns. It is common knowlege that corporate operating losses often lead to corporate liquidation. Therefore, the likelihood that an otherwise qualifying corporation may be liquidated is not a factor that should be considered in order to justify a judicial restriction upon the right to elect the tax treatment Congress granted by Subchapter S. See Patty, *Qualification and Disqualification Under Subchapter S*, N. Y. U. 18th Inst. on Fed. Tax 661, 665 (1960).

Further valuable evidence of the statutory policy allowing an election even though liquidation is foreseeable is the Commissioner's refusal to make a pertinent proposed regulation a part of his final regulations. Proposed Treas. Reg. §1.1372-1(a)(2) provided in part:

> [A] corporation is not eligible to make an election under Sec. 1372(a) if it is in the process of complete or partial liquidation, if it has adopted a plan of such liquidation, or if it contemplates such liquidation or the adoption of a plan of such liquidation in the near future.

By not adopting this regulation the Commissioner would appear to have indicated his own belief that the policy behind Subchapter S permitted small business corporations to elect the benefits of the statute even though corporation liquidation was contemplated. Treas. Dec. 6432, 1960 Int. Rev. Bull. No. 1 at 317.

The trustee has a further argument in support of his position that it is unfair to the corporate creditors to permit the sole shareholder to use on his personal income tax return the corporation's net operating loss deduction. The trustee informs us that because of the limitation in I. R. C. §1374(*c*)(2) on the extent to which a shareholder may avail himself of his corporation's net operating loss, see note 1, *supra*, a large part of the net operating loss deduction here at issue will likely go unused, and an undeserved benefit will thereby be bestowed upon the Government. This contention is summarily answered by pointing out that tax benefits offered by the Code frequently turn out to be unavailable to taxpayers because of rather rigid statutory limitations Congress placed upon the right to receive those benefits.

The trustee has failed to show us a convincing reason why Section 1374 should not be interpreted in accordance with its obvious meaning.

Judgment affirmed.

Appendix II

Judgment of United States Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the eighteenth day of September one thousand nine hundred and sixty-two.

Present:

HON. STERRY R. WATERMAN,
HON. IRVING R. KAUFMAN,
HON. THURGOOD MARSHALL,
Circuit Judges.

In the Matter

of

NOVO-PLAS MFG. CO., INC.,

Bankrupt,

NATHAN HAUPTMAN,

Trustee-Appellant.

Appeal from the United States District Court for the Eastern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Eastern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said District Court be and it hereby is affirmed.

A. DANIEL FUSARO
Clerk

APPENDIX III

Title 28 U. S. C. 1254

Title 28 U. S. C.

§1254. Court of appeals; certiorari; appeal; certified questions.

Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

(1) By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;

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No. 670

In the Supreme Court of the United States

October Term, 1962

NATHAN HAUPTMAN, TRUSTEE, PETITIONER

v.

DIRECTOR OF INTERNAL REVENUE, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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No. 670

NATHAN HAUPTMAN, TRUSTEE, PETITIONER

v.

DIRECTOR OF INTERNAL REVENUE, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. 18) is reported at 309 F. 2d 62. The opinions of the bankruptcy referee (R. 12a–20a)[1] and of the district court (Pet. 16–17), are not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on September 18, 1962. (Pet. 24.) The petition for a writ of certiorari was filed on December 17, 1962. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

[1] "R." refers to the appendix to the appellant's brief in the court of appeals.

QUESTION PRESENTED

Whether the taxpayer-corporation's election to be taxed as a small busines. orporation, in accordance with Subchapter S of ıe Internal Revenue Code of 1954, was valid and effective.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 172. NET OPERATING LOSS DEDUCTION.

* * * * *

(h) [as added by Sec. 64(b), Technical Amendments Act of 1958, P.L. 85–866, 72 Stat. 1606] DISALLOWANCE OF NET OPERATING LOSS OF ELECTING SMALL BUSINESS CORPORATIONS.—In determining the amount of the net operating loss deduction under subsection (a) of any corporation, there shall be disregarded the net operating loss of such corporation for any taxable year for which such corporation is an electing small business corporation under subchapter S.

* * * * *

SUBCHAPTER S [as added by Sec. 64(a), Technical Amendments Act of 1958, *supra*]—ELECTION OF CERTAIN SMALL BUSINESS CORPORATIONS AS TO TAXABLE STATUS

* * * * *

SEC. 1372. ELECTION BY SMALL BUSINESS CORPORATION.

* * * * *

(c) WHERE AND HOW MADE.—

* * * * *

(2) TAXABLE YEARS BEGINNING BEFORE DATE OF ENACTMENT.—An election may be made under

subsection (a) by a small business corporation for its first taxable year which begins after December 31, 1957, and on or before the date of the enactment of this subchapter, and ends after such date at any time—

(A) within the 90-day period beginning on the day after the date of the enactment of this subchapter, or

(B) if its taxable year ends within such 90-day period, before the close of such taxable year.

* * * * * *

SEC. 1374. CORPORATION NET OPERATING LOSS ALLOWED TO SHAREHOLDERS.

(a) GENERAL RULE.—A net operating loss of an electing small business corporation for any taxable year shall be allowed as a deduction from gross income of the shareholders of such corporation in the manner and to the extent set forth in this section.

* * * * * *

STATEMENT

For the taxable years 1955 and 1956 the Novo-Plas Manufacturing Company, Inc., reported and paid income taxes on taxable income in the approximate sum of $29,000. In 1957 the corporation suffered a net operating loss of $10,424.93. The corporation allegedly suffered a net operating loss of $184,535.70 for the year 1958. (Pet. 2, 18.)

Subchapter S (Sections 1371–1377) of the Internal Revenue Code of 1954, added to the Code by the Technical Amendments Act of 1958, permits qualifying small business corporations to elect to be treated for

tax purposes in a manner similar to partnerships or sole proprietorships, with the corporation not being treated as a taxable entity and with the stockholders directly reporting, on their individual returns, their aliquot shares of the corporation's net income or operating loss. Novo-Plas qualified as a small business corporation and on November 29, 1958—within 90 days of the adoption of Subchapter S—made a timely election to have those provisions apply for the calendar year 1958 and subsequent years. Pursuant to that election, the sole stockholder of the corporation (Raymond Zurawin) has filed a claim for refund utilizing the corporation's 1958 operating loss as a basis for a refund of individual income taxes paid by him, which claim for refund remains pending.

On January 23, 1959, Novo-Plas made an assignment of its assets for the benefit of creditors which was duly filed under New York law. On February 16, 1959, an involuntary petition in bankruptcy was filed against the corporation, and on March 23, 1959, it was adjudged a bankrupt. (Pet. 18.) The District Director of Internal Revenue has filed a claim in the bankruptcy proceeding for $7,155.61 in employment, social security, and withholding taxes unpaid and due for the years 1958 and 1959.

On September 2, 1959, petitioner, the trustee in bankruptcy, filed a claim for refund of corporation income taxes paid for 1955 and 1956 based upon a carryback to those years of the corporation's 1958 operating loss.[2]

[2] A claim based on the carryback of the 1957 loss was also filed, but that is admittedly allowable and is not in issue.

Asserting that claim as an offset against the Director's claim in the bankruptcy proceedings, the trustee moved the referee in bankruptcy for an order requiring the Director to recognize the trustee as the party entitled to utilize the corporation's 1958 operating loss and restraining the stockholder from utilizing the loss as a basis for refund of his individual income taxes. The referee held that, inasmuch as the corporation satisfied the requirements of Subchapter S and had made a timely election, the stockholder was entitled to report the operating loss on his individual return and, hence, it was unavailable for use as a carryback deduction by the corporation (R. 12a–20a). The district court affirmed the referee's order (Pet. 16–17) and was in turn affirmed by the court of appeals (Pet. 18–23).

ARGUMENT

1. The decision of the court below is correct, there is no conflict and no question of importance requiring review by this Court. The trustee argues, in effect, that the corporation should be allowed to carry back to prior years the alleged net operating loss for 1958 because the net operating loss is a "tax credit" belonging to the bankrupt corporation. (Pet. 8, 9.) But the statute allowing the net operating loss specifically provides, in unqualified terms, that a corporation is denied the benefits of such operating loss in any year in which a corporation is an electing small business corporation under Subchapter S. Section 172(h) *supra*, p. 2. And there is no dispute that Novo-Plas Manufacturing Company, Inc., was such a corporation.

It is the contention of the trustee that the provisions of Section 1374, which pass the corporate net operating loss through to the shareholders, do not apply when the corporation makes an otherwise valid Subchapter S election at a time when the corporation is insolvent or liquidation is contemplated. The trustee is thereby attempting to engraft a restriction upon the provisions of Subchapter S which was not provided nor intended by Congress. The essence of the trustee's argument is that the provisions of Subchapter S were enacted solely to benefit going, operating corporations and that Congress only intended to give the benefits of Subchapter S to corporations intending to continue in business. Section 1374 of the Internal Revenue Code of 1954, however, invites shareholders of small business corporations to avail themselves of the tax advantage derived from using their corporation's net operating losses as deductions on their personal income tax returns. As the court below pointed out (Pet. 22):

> * * *. It is common knowledge that corporate operating losses often lead to corporate liquidation. Therefore, the likelihood that an otherwise qualifying corporation may be liquidated is not a factor that should be considered in order to justify a judicial restriction upon the right to elect the tax treatment Congress granted by Subchapter S.

2. *Pepper* v. *Litton*, 308 U.S. 295, much relied upon by the trustee (Pet. 12–14), is not in point. No such statutory direction as is here contained was there present. Here a statute expressly prevents an electing small business corporation from obtaining the ben-

efits of a net operating loss and the statutory language authorizing the deduction does not contain the limitation upon the shareholders' power to cause a corporation to elect which taxpayer seeks to engraft upon it. In any event, in this proceeding the bankruptcy court has no summary jurisdiction over the shareholder or any right which the shareholder may have received by virtue of the Subchapter S election. See *Cline* v. *Kaplan,* 323 U.S. 97; *Harrison* v. *Chamberlin,* 271 U.S. 191; *Thompson* v. *Dachner,* 214 F. 2d 922 (C.A. 9th); *Ford* v. *Magee,* 160 F. 2d 457 (C.A. 2d); *In re Meiselman,* 105 F. 2d 995 (C.A. 2d). In the last analysis, the question whether the election can be made to the detriment of corporate creditors is in reality a controversy over the fiduciary responsibility of the corporate officers and shareholders. Whether or not such issues are substantial, they are not properly before this Court, but rather must wait the institution of a plenary action by the trustee against the shareholder.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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